IN THE

Supreme Court of the United States

OCTOBER TERM, 1962.

No. 240.

ANDRE MAXIMOV, as Trustee for the Benefit of H. ROBBIN FEDDEN, u/a dated 10/24/47,

Petitioner,

against

THE UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR PETITIONER.

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Opinions Below.

The opinion of the United States District Court for the Southern District of New York (R. 17-18) is not officially reported. The opinion of the United States Court of Appeals for the Second Circuit (R. 20-30) is reported at 299 F. 2d 565.

Jurisdiction of this Court.

The jurisdiction of this Court is invoked under 28 U. S. C. 1254(1).

The judgment of the United States Court of Appeals was entered on February 14, 1962 (R. 30).

The petition for a writ of certiorari was timely filed on July 10, 1962 and was granted on October 8, 1962 (R. 32).

Treaties, Statutes and Regulations Involved.

Article XIV of the Income Tax Convention with the United Kingdom (hereinafter sometimes referred to as the "Treaty") provides:

> "A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on gains from the sale or exchange of capital assets."

The text of the Treaty and material parts of the Internal Revenue Code of 1954 relating to the taxation of trust income are printed in our Appendix separately bound.

Section 894 of the Internal Revenue Code of 1954 (26 U. S. C. 1958 ed. §894) provides:

> "SEC. 894. INCOME EXEMPT UNDER TREATY
>
> Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle."

Section 22(b)(7) of the Internal Revenue Code of 1939, 53 Stat. 10, was to substantially the same effect, and was first enacted as Section 22(b)(7) of the Revenue Act of 1936, 49 Stat. 1658.

Section 7852(d) of the Internal Revenue Code of 1954 (26 U. S. C. 1958 ed. §7852(d)) provides:

> "(d) Treaty Obligations.—No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title."

A similar provision first appeared as Section 109 of the Revenue Act of 1942, 56 Stat. 808, and was found in each

successive Revenue Act until Section 7852(d) was incorporated as part of the Internal Revenue Code of 1954.

Treasury Decision 5569 comprises the Commissioner's regulations applicable to the Treaty. 1947-2 Cum. Bull. 100. Section 7.519, subparagraph (c), of T. D. 5569 provides:

> "(c) *Beneficiaries of an Estate or Trust.*—A nonresident alien who is a resident of the United Kingdom and who is a beneficiary of a domestic estate or trust, shall be entitled to the exemption, or reduction in the rate of tax, as the case may be, provided in Articles VI, VII, VIII, IX and XIV of the convention with respect to dividends, interest, royalties, natural resource royalties, rentals from real property and capital gains to the extent such item or items are included in his distributive share of income of such estate or trust if he is taxable in the United Kingdom on such income and is not engaged in trade or business in the United States through a permanent establishment."

Section 7.514 of T. D. 5569 sets forth the specific classes of income from sources within the United States which are considered exempt under the Treaty. Among these are:

> "(g) Gains from the sale or exchange of capital assets by a non-resident alien who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom, if such alien or corporation has no permanent establishment in the United States (Article XIV);"

Question Presented.

Does the exemption accorded by Article XIV of the United Kingdom Treaty embrace capital gains on property held in a domestic trust, where such gains are retained as corpus for future distribution and when all the benefi-

ciaries of the trust, the income beneficiaries and remaindermen alike, are residents of the United Kingdom not engaged in trade or business in the United States?

Statement of the Case.

1. The Facts.

The petitioner is the duly qualified successor trustee of an *inter vivos* trust created on October 24, 1947 by H. Robbin Fedden (hereinafter sometimes referred to as the grantor) (R. 9-15, 16). Under the trust instrument the income is payable to the grantor during his lifetime. On his death the income is to be paid during her life to his wife, should she survive him and be married to him upon his death. Upon the deaths of the grantor and his wife the principal is to be paid over to the grantor's then surviving issue in equal shares per stirpes, or if any such issue shall be under twenty-one years of age, shall be retained in trust for his benefit until he reaches twenty-one years. If no issue survive the grantor and his wife, the principal shall be paid over to such persons as the grantor shall appoint by will or if he shall fail to do so, under the laws of intestate succession of the State of Connecticut (R. 10-11).[1]

During 1954 and 1955 the grantor, H. R. Fedden, his wife, Renee Fedden, and his children (Katherine, age 16, and Frances, age 12, as of November, 1960) who constituted their only issue, were citizens and residents of the United

[1] In addition, under the trust instrument, the trustee is granted the power under certain circumstances to pay over any of the principal to the then income beneficiary. The grantor has certain powers over investments and also reserves the right to terminate the trust at any time after twenty years from the date of its creation on six months notice (R. 11, 12, 15). While these additional facts might have formed the basis for an argument that the grantor rather than the trustee was the taxpayer in respect of the capital gains involved in this case under the provisions of Sections 671-677 of the Internal Revenue Code of 1954, this argument was not made in the proceedings below or in the petition for certiorari, and is not raised by petitioner before this Court.

Kingdom and were not engaged in trade or business in the United States (R. 16-17). Since October, 1947, the grantor has been employed in the United Kingdom by the National Trust for Places of Historic Interest or Natural Beauty, and since January, 1951, has held the position of Historic Buildings Secretary. He has been in the United States only once, in October of 1958, for a period of about three weeks on a speaking tour on behalf of the National Trust (R. 17).

During its taxable years 1954 and 1955 the trust realized capital gains from the sale of securities (R. 2-3). These gains were allocated to the principal of the trust under Connecticut law, which by the terms of the trust instrument governs the rights of the parties interested in the trust estate (R. 7, 14). The trustee duly filed Federal income tax returns reporting such gains, and paid the District Director of Internal Revenue capital gains taxes thereon of \$53.10 for 1954 and \$1,316.32 for 1955 (R. 2). Thereafter, claims for refund were filed with the District Director of Internal Revenue, asserting that such taxes were erroneously collected (R. 4-8). These claims for refund were denied in full (R. 3).

2. The Proceedings Below.

Petitioner brought an action for the recovery of such taxes in the United States District Court for the Southern District of New York, the jurisdiction of which was invoked under 28 U. S. C. 1346(a)(1) (R. 2-3). The Court, in a memorandum opinion dated January 4, 1961 by Judge MacMahon, on cross-motions for summary judgment, held for the plaintiff. Judge MacMahon based his decision upon the decision of the United States Court of Appeals for the Ninth Circuit in *American Trust Company v. Smyth*, 247 F. 2d 149 (1957), observing that in the *American Trust*

Company case, the Court held that the intent of the Convention was to effect full reciprocity and equality of tax treatment between nationals of the two countries and that the individual beneficiaries who would feel the economic burden of the tax were entitled to the exemption provided by the treaty (R. 17-18). Judgment for the plaintiff was entered on January 4, 1961 (R. 18).

On February 28, 1961 the respondent appealed from this judgment to the United States Court of Appeals for the Second Circuit (R. 20). On February 14, 1962 that Court, in an opinion by Judge Clark, reversed the District Court and held that while currently distributable capital gains realized by a United States trust are exempt from Federal income tax under the Convention, capital gains which are held for future distribution are not exempt. The Court rested its decision on the grounds that "the exemption of Article XIV explicitly applies only to residents of the United Kingdom", the "trust is not a United Kingdom resident and the income here is treated in United States law as that of the trust" (R. 22-3) and the "technical language" of the Treaty, "in conjunction with the Internal Revenue Code, as incorporated by Article II(3), recognizes the trust as a separate taxable entity" (R. 28).

In conjunction with the foregoing analysis, the Court below found that "the broad aim of the Convention, as with income tax treaties generally, was to facilitate commercial enterprise between the two countries", that the "prime target was double taxation" and that a "primary motivation for inclusion of provision equalizing tax treatment such as Article XIV was reduction of tax barriers to the free movement of individuals for commercial purposes" (R. 27-8). The Court concluded:

> "And exemption here is unnecessary to achieve these ends. There can be no double taxation, since

neither the beneficiary nor the ultimate recipients of the corpus will be taxable in the United Kingdom on these gains. Thus we cannot see that such an exemption would affect commercial intercourse between the two countries in any significant manner" (R. 28).

Summary of Argument.

1. The question as to whether the exemption accorded residents of the United Kingdom embraces gains on the sale of securities held in a domestic trust, when the gains are retained for future distribution, depends on the meaning of the word "exempt" as used in context and in light of the purpose of Article XIV. The sole purpose of Article XIV was to match a pre-existing British exemption, and thus provide complete exemption from taxation. In order to carry out the reciprocal purpose of the Article, the term "exempt" must be construed in accordance with its commonly understood meaning, signifying release from the economic burden of tax. Capital gains are not taxed in the United Kingdom on the theory that such gains represent capital or corpus and not income or profits. It is irrational in applying this Treaty exemption to make a distinction between distributed and undistributed capital gains where such gains are accumulated under state law because they are regarded as part of the trust corpus and not income. More restrictive language, suggestive of the narrow construction pressed by the Government in this case was readily available and exists in earlier treaties but was discarded in the United Kingdom Treaty.

2. In the course of the Treaty negotiations, the United Kingdom insisted that the tax laws of the respective countries be placed on a reciprocal basis before accepting

provisions for exchange of information and reciprocal enforcement. The Treaty thus secures exemptions for investment income solely in order to achieve reciprocity in areas unrelated to commercial enterprise, double taxation or fiscal evasion. An article-by-article analysis of the Treaty shows the extent to which the negotiators sought to achieve reciprocity and equality in terms of economic burden in tax treatment of the nationals of each country.

3. The economic burden of a tax imposed upon gains in trust necessarily falls upon the trust beneficiaries, and not upon the trustee, who acts in a fiduciary capacity only. In the years the taxes were imposed, the United Kingdom beneficiaries were presumptive takers of the accumulated gains and, as residents of the United Kingdom, qualified for the treaty exemption. The facts as they existed in the years of sale are controlling notwithstanding possible future change in the exempt status of the beneficiaries.

4. The concept of a trust as a "separate taxable entity" is not recognized for all purposes in the Treaty and is not an inviolate principle of domestic taxation. The Treaty definitions, read in conjunction with domestic law, do not defeat the exemption when applied to the gains here involved. Clear, overriding language that would unquestionably tax the gains to the United States trust in this case, found in all tax treaties in effect before the United Kingdom Treaty was signed and in most treaties since, was significantly omitted from the United Kingdom Treaty. Our domestic scheme of taxing trusts insures that taxable income is taxed at least once, either to the beneficiary if the income is distributed or to the trust if the income is accumulated, but a trust does not change the character of the

income and does not create a tax on income that is intended to be exempt.

5. Congress has specifically provided that treaty obligations of the United States, including exemptions from gross income, should have full force and effect notwithstanding any provision of our Internal Revenue Code to the contrary. There is therefore no reason to introduce domestic tax concepts into the construction of Article XIV when, as in this case, to do so would defeat its primary objective. Instead, Article XIV should be liberally construed so as to carry out the apparent intention of the parties to secure equality and reciprocity between them.

6. The Treasury Regulations under the Treaty are patently defective and their application would render Article XIV almost totally inoperative in the case of gains realized by a domestic trust. While these Regulations are similar to the regulations interpreting earlier tax treaties, those conventions contain different language from Article XIV and, unlike the United Kingdom Treaty, expressly provide for the promulgation of interpretative regulations. Therefore, the Regulations should not be given controlling weight.

ARGUMENT.

I.

The Exemption Accorded by Article XIV Embraces Capital Gains on Property Held in a Domestic Trust, Whether Such Gains Are Currently Distributable or Are Retained for Future Distribution.

1. Article XIV Must Be Construed to Relieve the United Kingdom Beneficiaries from the Burden of Capital Gains Tax in Order to Secure the Equality and Reciprocity to Which Article XIV Was Addressed.

The petitioner maintains that not only Article XIV but the Treaty as a whole indicates an objective to accomplish reciprocity in terms of economic burden of tax. It is first necessary, however, to examine the terms of the Convention, and relevant precedents in our domestic law, to determine the meaning of the term "exempt" in the context of Article XIV.

Article XIV provides in broad and simple language:

> "A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on gains from the sale or exchange of capital assets."

The only guidance as to the meaning of the terms used in Article XIV may be found in Article II(3) of the Treaty, which provides:

> "In the application of the provisions of the present Convention by one of the Contracting Parties any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting Party relating to the taxes which are the subject of the present Convention."

Article II(3), as a reading of it indicates, is directed at any "term" of the Treaty not otherwise defined. The only "terms" in Article XIV with which we are concerned are "A resident of the United Kingdom", "engaged in trade or business in the United States", "exempt", "sale or exchange" and "capital assets". The term "trust" does not appear in Article XIV or elsewhere in the Treaty.[2]

It is not disputed that all the beneficiaries, the income beneficiaries and remaindermen alike, are "residents of the United Kindom", "not engaged in trade or business in the United States", and that the gains involved are "gains from the sale or exchange of capital assets". The answer to the question whether the exemption accorded residents of the United Kingdom embraces gains on the sale of securities held in a domestic trust, when the gains are retained for future distribution, necessarily depends on the meaning of "exempt" or "exempt from United States tax" as used in context and in light of the purpose of Article XIV.

The term "exempt" is nowhere defined in the Treaty or in our Internal Revenue Code.

An analysis of our revenue laws shows that there was and is no uniform or consistent meaning attaching to the word "exempt". In certain instances it is coupled with the words "credits" or "deductions"[3]; in other instances it is

[2] By way of contrast, a corporation is defined in Article II(1)(d) and (e) as a distinct "entity" or "juridical person". Nowhere in the Treaty is a trust accorded recognition as an "entity" or "juridical person".

[3] The Internal Revenue Code of 1939, rather than the Internal Revenue Code of 1954, was in effect at the time the United Kingdom Treaty was negotiated and made effective. Some of the terms used in the 1954 Code have been changed without any intended substantive change in meaning, as the context indicates. Section 25 of the 1939 Code authorizes the "following credits against net income" including "an exemption of $600 for the taxpayer" and additional "exemptions of $600 for his spouse and for each dependent" 62 Stat. 112. Section 151 of the 1954 Code, 26 U. S. C. §151, allows such exemptions as "deductions" in computing taxable income.

in addition to the phrase "shall not be included in gross income"[4]; and in some the word "exempt" attaches to a defined institution,[5] or attaches to the item, regardless of the recipient of the item.[6] Thus, the precise meaning in which the word is used depends entirely upon the context.

In the absence of a fixed statutory definition of a word, it is appropriate to conclude that the word is to be given its normal meaning. The generally accepted meaning of "exempt", as defined in our standard dictionaries of the English language, is "to free, except, or excuse from some burdensome condition or obligation, or the operation of some law to which others are subject." Funk & Wagnalls, *New Standard Dictionary of the English Language*, 872 (1947 ed.). The 1950 edition of the same publication, carried a secondary meaning, "free or excused from some burden or obligation; as exempt from taxation" *id.* at 348.

Our courts have frequently adopted and applied this meaning. *Maine Water Co.* v. *City of Waterville*, 93 Me. 586, 45 Atl. 830, 833 (1900); *In re Matter of Sowers*, 60 N. C. 459, 461 (1864); *Koenig* v. *Omaha & N. W. R. Co.*, 3 Neb. 373, 380 (1874); *Florer* v. *Sheridan*, 137 Ind. 28, 36 N. E.

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[4] Section 22(b) of the 1939 Code reads "the following items shall not be included in gross income and shall be exempt from taxation" 53 Stat. 10. See also Section 894 of the Internal Revenue Code of 1954, 26 U. S. C. §894.

[5] Thus Section 501(a) of the 1954 Code provides that certain described organizations "shall be exempt from taxation under this subtitle" 26 U. S. C. §501(a).

[6] A well known example is interest on obligations of a state, territory or any political subdivision thereof. Section 22(b)(4) of the 1939 Code provides that such items "shall not be included in gross income and shall be exempt from taxation under this chapter", 53 Stat. 10, whereas Section 103(a) of the 1954 Code simply provides that "gross income does not include interest on—(1) the obligations of a state, territory or possession of the United States", etc., 26 U. S. C. §103(a).

365, 369 (1894). Thus in *Maine Water Co.* v. *City of Waterville, supra,* the Supreme Court of Maine said:

> "The term 'exemption' implies a release from some burden, duty, or obligation. 'It is a grace, a favor, an immunity; taken out from under the general rule, not to be like others who are not exempt; . . . .'"

In the context of Article XIV, the term "exempt" should be taken at its ordinary meaning, and not in any artificial or narrow technical sense, unless such restricted sense is clearly intended. See *Geofroy* v. *Riggs,* 133 U. S. 258, 271 (1890). The Ninth Circuit in *American Trust Company* v. *Smyth* accordingly held that the term "exempt" as used in Article XIV "was employed in its broadest meaning, signifying a release from economic burden" (247 F. 2d at 153), and embraced capital gains held in a domestic trust and retained for future distribution. In the words of the Ninth Circuit (p. 152):

> "We conceive the purpose of the Treaty to have been full reciprocity and equality of tax treatment between nationals of the United States and the United Kingdom. Such being the case, this purpose requires a broad construction of Article XIV, so as to relieve the British beneficiaries from the burden of the capital gains tax to the same extent, in a given situation, as a United States beneficiary would be in a similar position in the United Kingdom."

The sole object of Article XIV was to equalize tax treatment between the nationals of the two countries with respect to capital gains. The United States has treated such gains or profits as taxable income, taxing the gains as ordinary income if the property sold is held for less than a stated period (now six months), and if held for a

longer period at not in excess of a flat rate (now 25%). The United Kingdom has not taxed such gains,[7] except in the case of so-called "trading profits" not applicable in the case of the sales here involved. This difference in rule applies generally, whether the property sold is owned outright or is held in trust. Thus in the case of a United Kingdom trust with the life beneficiaries and remaindermen all residents of the United States, a gain realized on a sale by the trustee of the trust corpus is not subject to tax in the United Kingdom. Here we have involved a reverse but like situation.

The parties who negotiated the Treaty clearly conceived of Article XIV as a provision designed to grant reciprocity to residents of the United Kingdom. The Technical Memorandum of the Treasury Department on the Treaty, Exec. Rept. No. 4, 79th Cong., 2d Sess. 12 (1946) (hereinafter cited as Senate Report), after discussing the fact that capital gains are not included in the United Kingdom tax base unless regarded as a trading profit, makes the following observation (p. 19):

> "It is because of this factor [the difference in tax systems] that it was found impracticable to make the Article [XIV] reciprocal on its face even though it is so in fact."

Notwithstanding this historical background of Article XIV, the Court below argued that "the broad aim" of the Convention was to facilitate commercial enterprise,[8] that

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[7] After the adoption of the Treaty, and after the sales here involved, the United Kingdom, under Section 10 of the Finance Act of 1962, 10 & 11 Eliz. 2. Ch. 44, imposed income tax upon the disposition of land within three years after its acquisition and upon the disposition of other property within six months after its acquisition.

[8] The Court below cited as its authority for this statement a memorandum prepared for the Committee on Foreign Relations which is printed in the Hearings on the Income and Estate Tax Conventions with the United Kingdom before a Subcommittee of

its "prime target" was the problem of double taxation. (R. 27-28) and that:

> "* * * exemption here is unnecessary to achieve these ends. There can be no double taxation, since neither the beneficiary nor the ultimate recipients of the corpus will be taxable in the United Kingdom on these gains. Thus we cannot see that such an exemption would affect commercial intercourse between the two countries in any significant manner." (R. 28)

This analysis is based on a fundamental misconception of the objectives which Article XIV and the Treaty as a whole were intended to accomplish. Indeed, if the analysis of the Court below were correct, Article XIV has no place in the Treaty.

As we will show below in Section 2, the Treaty has as much to do with investment income as with commercial profits,[9] and Article XIV, as well as other articles, deals primarily with investment rather than business income.[10] Similarly, if, as the Court below stated, the "prime target" of the Treaty was "double taxation", there would be no reason for the existence of Article XIV since even with its exclusion there could have been no double taxation in view of the absence of any British tax on capital gains.

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the Committee on Foreign Relations of the United States Senate, 79th Cong. 1st Sess. pp. 23, 27 (1945) (hereinafter cited as Hearings). However, the memorandum merely states that this was "one of the basic objectives of the Convention".

[9] *Infra* pp. 19-23.

[10] The position urged by the government in this case might tend to limit use of United States trusts by United Kingdom residents, who would be more likely to establish trusts in jurisdictions other than the United States which impose no tax upon capital gains. Such a result can only be detrimental to the financial community in the United States vis-a-vis competing foreign financial institutions, without compensating increase in tax revenues for the United States and indeed with the likelihood of a net reduction in such revenues.

The sole purpose of Article XIV was to match a pre-existing British exemption, and thus provide complete exemption from taxation. Single, not double taxation was the barrier to be removed.

The Court below also pointed to different concepts of capital gains in the United States and the United Kingdom and accordingly observed that Article XIV "does not achieve complete equality" (R. 25). However, in the instances referred to by the Court below in which the United Kingdom imposes its standard tax on transactions which are considered to be the sale or exchange of capital assets under United States law, both the Treasury Memorandum in the Senate Report (p. 19) and the testimony at the Hearings (p. 75) show that this result was recognized as an exception to the general equality provided by Article XIV and was accepted as such.[11] These exceptions should not be allowed to obscure the fact that the overriding purpose of Article XIV was to achieve equality. Whatever fringe areas of differences in concept may exist, the one clear case in which the concept of capital gain is the same under the tax laws of both parties to the Treaty is the gain from the sale of capital assets held in trust. A trustee or fiduciary is governed by the rule of the "prudent" investor, and

[11] These transactions, which the United Kingdom regards as involving trading profits, are similar to the trading activities which this Court in *Corn Products Refining Co.* v. *Commissioner*, 350 U. S. 46 (1955) has held do not constitute the sale or exchange of capital assets, notwithstanding the fact that none of the exceptions to the definition of "capital asset" contained in 1939 Code Section 117(a) 53 Stat. 50 (1954 Code Section 1221) literally applied to the assets involved in that case. Subsequent cases have interpreted the *Corn Products* decision as holding that the concept of capital gains is a restricted one, which should be narrowly interpreted wherever possible. *Greene-Haldeman* v. *Commissioner*, 282 F. 2d 884 (9th Cir. 1960), *Lockhart* v. *Commissioner*, 258 F. 2d 343 (3d Cir. 1958). Thus, many of the apparent diversities in the definition of capital gains between the United States and the United Kingdom are more illusory than real and their scope is substantially less than the Court below has indicated.

typically does not engage in trading profits or short term speculation.

It is not disputed that the exemption in Article XIV applies to capital gains on the sale of property held by a United States trustee in trust for British beneficiaries. It is contended only that the exemption is inapplicable when the gains are held for future distributions. Yet in applying the treaty exemption, it is irrational to make a distinction between distributable and undistributed capital gains. In both instances the gains arise on the sale of property held in trust and the trustee holds the legal title of the property sold. Whether the gain is distributable or not distributable, the trustee acts in a representative capacity only. In both instances the economic burden of the tax falls on the beneficiaries.

No distinction between distributed or retained capital gains is made for United Kingdom tax purposes in the reverse situation, when the trust is located in the United Kingdom, and the beneficiaries are resident in the United States.[12]

Capital gains of the kind here involved have been exempt in the United Kingdom on the theory that such gains

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[12] The Court below cited Harvard Law School, World Tax Series, Taxation in the United Kingdom, ¶¶5/3.1, 5/3.4, pp. 125, 127 (1957) in Footnote 2 (R. 23) to the effect that under British law, the term "person" encompasses a trust.

The cited volume of the World Tax Series points out that a trustee is not assessed with surtax in respect of trust income (¶10/7.1, p. 307) and that for surtax purposes, income which has accumulated in trust is includable in the total income of a beneficiary whose interest in the accumulation is vested. If the beneficiary's interest in accumulated income is contingent, such income is not taxable either to the trust or to the beneficiary (¶10/7.2, p. 308). On the other hand the standard tax is imposed on the trustee whether or not the income is distributed. However, the taxability of trust income from sources outside the United Kingdom in certain instances depends on the residence status of the beneficiary and not on the residence of the trust. ¶¶5/3.4, 10/7.1, pp. 127, 307.

represent capital or corpus and not income or profits.[13] In this country, where profit arises on the sale of property held in trust, in the absence of any direction in the trust instrument the profit is distributable or is retained for future distribution depending on the law of the state under which the trust is created. To the extent the state law disagrees with the British concept and regards such gains as income and not corpus, such gains would be distributable and the exemption under Article XIV would admittedly apply. Under the government's view of this case, however, to the extent state law agrees with the British concept and regards such gains as part of the trust corpus, our government seeks to remove such gain from the treaty exemption in the face of a treaty provision that has no other function than to match the British exemption.

Article XIV was drafted in broad and simple language. More restrictive language was readily available and exists in each of the three earlier tax treaties entered into by the United States. The earlier conventions no doubt served as convenient models, and no reason existed for departing from the language consistently available, except as concessions or "give and take" in the negotiations required. Thus, the conventions with Sweden[14] and Canada[15] each provided:

> "Gains derived in one of the contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in

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[13] Harvard Law School, World Tax Series, Taxation in the United Kingdom, ¶9/8.1, p. 277.

[14] Article IX (54 Stat. 1764), effective January 1, 1940.

[15] Article VIII (56 Stat. 1402), effective January 1, 1942. Article 11 of the French Treaty (59 Stat. 899), effective January 1, 1945, is similar except that the words "stocks, securities or commodities" appear in the place of the words "capital assets".

the former State, provided such residents or corporation or other entity has no permanent establishment in the former State."

As in the case of the United Kingdom, Sweden, Canada and France did not tax capital gains in any event, and therefore there was no more reason to phrase the capital gains provisions in those treaties in reciprocal terms than in the case of the United Kingdom Treaty. Yet, the terms gains "derived" from the "sale" or exchange "by a resident or a corporation or other entity" were discarded in the United Kingdom Treaty for the broad mandate that a "resident of the United Kingdom" not engaged in trade or business in the United States "shall be exempt from United States tax on gains from the sale or exchange of capital assets." Viewed in the context of the reciprocity which Article XIV was intended to accomplish, this change of language cannot be ignored.

2. Throughout the Treaty A Prime Objective Was the Accomplishment of the Fullest Possible Reciprocity of Treatment in Terms of Economic Burden of Tax.

As the Court below recognized (R. 24), in determining the scope of the exemption contained in Article XIV, the several articles of the Treaty as a whole must be considered in order to determine the intent of the negotiators. *In re Ross*, 140 U. S. 453, 475 (1891); *Rocca* v. *Thompson*, 223 U. S. 317, 331-332 (1912). However, the analysis of the "broad aim" of the Treaty by the Court below closely follows the original intent of the United States, but not the intent of the United Kingdom. The United States was primarily interested in establishing mutual credit provisions in order to avoid double taxation. The United Kingdom preferred a source exemption system. The United States preferred system was finally adopted for "business

income" or "commercial profits" and the United Kingdom preferred system was adopted for "investment" income. Thus Eldon P. King, Special Deputy Commissioner, Bureau of Internal Revenue, testified before a Subcommittee of the Senate Foreign Relations Committee as follows (Hearings, *supra*, n. 7, p. 58):

> "Since in dealing with its own citizens, residents, and corporations, the United States has long employed a credit system through which it permits deduction of the foreign tax from the United States tax imposed on the foreign income, it has naturally turned to this solution as a part of a tax-convention plan. It was found, however, that Britain preferred the more direct system of eliminating double taxation through exemption from tax at source so the convention reflects a compromise of the two plans. Thus, in most matters of business income and in certain instances affecting earned income, the credit system is employed as a means of eliminating double taxation, while in most matters of investment income the source exemption system is used."

The United States was also interested in problems of fiscal evasion, but this proved an initial barrier for the conclusion of the Treaty. In the words of Eldon P. King (Hearings, pp. 56-7):

> "In a preliminary exploration with Britain in 1937 looking toward a tax convention, it was recognized that the British policy of fiscal secrecy and British objections to alleged extraterritorial practices on the part of the United States formed the greatest barriers to the conclusion of a tax convention between the two countries."

In the course of the negotiations, it became necessary to place the tax laws on a substantially reciprocal basis before a plan for reciprocal enforcement could be made acceptable

to the United Kingdom. Eldon P. King stressed the importance of this point in his testimony (Hearings, p. 57):

> "In certain instances in the present convention, such as those referred to in some of the committee's objections, the countries have proposed to place their laws on substantially a reciprocal basis before joining in a plan for reciprocal enforcement. It follows that should the United States desire to withdraw from some of such substantive provisions, Britain would be in a position to withdraw, wholly or qualifiedly, from the administrative provisions."

An article-by-article analysis of the Treaty bears out the extent to which the parties extended this concept of reciprocity. The Treaty, the full text of which is printed in the Appendix, contains twenty-four articles. Of these, seventeen undeniably secure thoroughgoing reciprocity, with mutually reciprocal provisions cast in virtually identical language, namely, Articles I-V, VII, VIII, X, XI, XII and XVIII-XXIV.

Articles V, VII, VIII, X, XI and XII contain mutually reciprocal exemption provisions. In view of the reciprocal tax credit provisions of Article XIII, these articles are unnecessary to eliminate the possibility of double taxation. Their significance is that they provide a complete parity of tax treatment for nationals of both parties which would not have existed in their absence. Also, despite the statement of the Court below that the aim of the Treaty was to facilitate commercial exchange between the two countries, Article VII exempts interest from tax only if the recipient is *not* engaged in trade or business in the country from which such interest is derived, and the exemption of royalties contained in Article VIII is similarly conditioned.

In Articles XIV, XV, XVI and XVII the prime target was single taxation. As in the case of capital gains in

Article XIV, in Articles XV[16] and XVI[17] (as well as Article XVII, which makes Articles XV and XVI effective in respect of prior unpaid taxes due by residents and corporations of the United Kingdom) the United States agreed to a tax exemption not otherwise accorded by our tax laws so as to match the United Kingdom rule, which did not impose any tax in corresponding situations. Memorandum Prepared for the Committee on Foreign Relations Hearings, *supra*, n. 7 at p. 25.

The remaining articles, namely Articles VI, IX and XIII especially illustrate the extent to which the negotiators went in assuring reciprocity from the standpoint of economic burden of taxation, disregarding the technical identity of the "taxpayer" under domestic law.

Article VI reduces the United States withholding tax on dividends received from a United States corporation by a United Kingdom resident (normally 30%) to 15%, while dividends received by a resident of the United States from a United Kingdom corporation are made exempt from the British surtax. At the time of the adoption of the Convention the corporate profits of a United Kingdom corporation were subject to British income tax at a standard rate of 50% and a national defense contribution of 5%, or 55%

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[16] Article XV exempts from United States tax dividends and interest paid by a United Kingdom corporation except where the recipient is a United States citizen or resident. Prior to the Treaty, the United States taxed dividends and interest paid to British residents (and other non-resident aliens) by a United Kingdom corporation which was engaged in business in and derived a certain percentage of its gross income from United States sources (20% in the case of interest and 50% in the case of dividends).

[17] By Article XVI a United Kingdom corporation engaged in business in the United States is made exempt from the United States tax on its accumulated and undistributed earnings, subject to the limitation that residents of the United Kingdom throughout the last half of the taxable year control more than 50% of the voting power.

in all. The stockholder obtained a credit for the purpose of the standard or normal tax equivalent to the tax paid by the corporation, but he was required to pay surtax on the entire dividend. At that time, the United States rate on corporate earnings was 40%. Thus by fixing the withholding rate on dividends received from an American corporation by a resident of the United Kingdom at 15% and at the same time exempting our residents from any surtax on dividends from a United Kingdom corporation, the Treaty placed on the residents of each of the contracting parties the same burden of tax on the pool of corporate earnings, at the rate of 55%.[18]

Article IX also adjusts dissimilar rates, taking account of dissimilarities in the tax base, in order to achieve reciprocal equivalence in the tax burden.[19]

Article XIII, the reciprocal credit provision, is the primary means adopted by the negotiators for eliminating double taxation. However, it is equally significant in that it represents major concessions by both countries in the interest of equality of tax treatment for the nationals of each. The

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[18] Bearing in mind that a change in tax rates by either country might upset the reciprocal balance achieved by Article VI, the parties added a clause, subparagraph (3) of Article VI, providing that either of the contracting parties might terminate Article VI by written notice on or before June 30th of any year after 1945.

[19] By Article IX the current United States withholding rate of tax on royalties from mines and other natural resources and on rentals from real property derived from sources within the United States by a United Kingdom resident was reduced from 30% to 15% of the gross amount received. On the other hand, similar royalties and rentals from sources within the United Kingdom derived by a United States resident were made exempt from the United Kingdom surtax, but under United Kingdom law were subject to the standard or normal tax at the prevailing 50% rate on the net amount received, *i.e.*, after credits and deductions. The testimony presented at the hearings makes it clear that a 15% tax on the gross receipts was viewed as approximately equivalent to a 50% tax on the net receipts. Memorandum Prepared for the Committee on Foreign Relations, Hearings p. 24.

United Kingdom made a major legal and policy adjustment by agreeing to adopt a provision for foreign tax credits; prior to the Convention, credits against the United Kingdom tax on account of foreign taxes paid were unknown under British law. Memorandum Prepared for the Committee on Foreign Relations, Hearings p. 29. The United States also made an important concession by providing that the foreign tax credit allowed United States residents on dividends from a United Kingdom corporation includes the United Kingdom standard tax paid by the British corporation. This represents a major departure from the United States tax law, for prior to the Treaty the Commissioner of Internal Revenue had maintained and this Court had held in *Biddle* v. *Commissioner*, 302 U. S. 573 (1938) that an American recipient of a dividend from a British corporation is not "the taxpayer" in respect of the United Kingdom standard tax paid by the corporation, and accordingly was denied any credit on account of such tax.

The Court below argued (R. 26-27) that the technical precision with which such provisions as Article VI (and presumably Article XIII) were drafted indicates that if an exemption had been contemplated under Article XIV for the undistributed gains realized by a trustee, Article XIV would have contained precise language to that effect. This argument overlooks the fundamental difference between the relationship of a stockholder to the corporate assets and the relationship of a beneficiary to property held in trust.[20] This distinction is recognized in the Treaty, where Article II(1)(d) and (e) specifically speak of a corporation

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[20] Compare *Helvering* v. *Hutchings*, 312 U. S. 393 (1941) with *Heringer* v. *Commissioner*, 235 F. 2d 149 (9th Cir. 1956), *cert. denied*, 352 U. S. 927 (1956). See also *Klein* v. *Board of Tax Supervisors*, 282 U. S. 19, 24 (1930): "The corporation is a person and its ownership is a non-conductor that makes it impossible to attribute an interest in its property to its members."

as a separate and distinct entity or juridical person. Thus, within the treaty itself it was necessary to state expressly the intended exceptions to corporate entity rules.

As shown above, the United States exacted important concessions from the United Kingdom in obtaining a breach in the wall of secrecy concerning exchange of information for enforcement purposes and in winning acceptance of mutual credits for foreign taxes. The United Kingdom in turn exacted important concessions in obtaining source exemptions and reciprocity. Reciprocity of treatment in terms of economic burden of tax was the insistent goal of the United Kingdom. It is left to this Court to see that the concessions or commitments on the part of the United States are carried out.

3. The Burden of the Tax Falls Upon the United Kingdom Beneficiaries in the Year of Sale; the Status of the Beneficiaries in the Year of Sale Is Necessarily Controlling.

The burden of tax here is on the Fedden family. The burden undeniably falls upon the remaindermen, for the corpus of the trust is depleted by the amount of the tax. The tax is also a burden upon the life beneficiaries, for the depletion of the corpus necessarily diminishes the income-producing property and so the current income distributable to such beneficiaries.

The trustee acts in a representative or fiduciary capacity only, and has only legal title to the trust property. Equitable ownership has more significance than the naked legal title of a trustee, and this has been recognized in tax disputes. Thus in *Commissioner* v. *Nevius,* 76 F. 2d 109 (2d Cir. 1935), *cert. denied,* 296 U. S. 591 (1935) a life beneficiary of a British trust who was a non-resident alien from our standpoint died holding a power of appointment over her share of the trust property, which consisted in

part of stock in American companies. The issue was whether the decedent "owned and held" the shares of stock in the trust fund, for if so the value of the shares so owned was subject to our estate tax. The United States Court of Appeals for the Second Circuit upheld the tax, saying that the decedent, although having a beneficial interest only in the trust corpus, "owned and held the stock". In the course of his opinion Judge Swan, who wrote for the Court said (p. 110):

> "Equitable interests are so common and so valuable that it is incredible that they should be excluded from taxation. The naked legal title of a trustee during the continuance of the trust has no pecuniary value."

In a concurring opinion Judge Learned Hand said (p. 111):

> "* * * it would, I think, quite contradict the whole scheme of the title to import a distinction between legal and equitable interests, whatever view one takes of equitable interests, whether as no more than rights in personam or as 'property.' Only lawyers make that distinction to-day and not many even of them; it would be pedantic to impute it to Congress, even in a tax statute. Therefore I think that the decedent 'owned and held' the shares at her death and that they were a part of her taxable gross estate."

The present economic burden of the tax would clearly fall on a vested remainderman in the United Kingdom. The equity courts of England and the courts of the United States have clothed the remainderman of a trust with major attributes of ownership of the trust property. An indefeasibly vested remainder is a present estate in being, with only the right of possession and enjoyment postponed until the

trust terminates and the remainder falls in. Where the remainder is defeasible, that is, vested but subject to being divested on a condition subsequent, the remainderman enjoys substantially the same rights with respect to the trust property so long as the remainder continues.

In the present case the gains here are accumulated for the benefit of the issue of the income beneficiary-grantor. Two issue were in being when the taxes were imposed, namely, the grantor's teen-age daughters (R. 16-17) and so long as they live the accumulations in the trust are for them. They were and remain the "presumptive" takers of the trust accumulations. If the death of the children should defeat their interests and if they should die without issue, the trust fund becomes subject to disposal by the grantor as he shall appoint by will or, if he should fail to appoint, according to the laws of intestate succession.

Thus it is clear that the Fedden family as a group or class, all resident in the United Kingdom, are the beneficial owners of the trust corpus and are burdened by the tax imposed in the year of sale. Their interests as a group or class are equivalent to vested remainder interests, with possible shifts of interest within the group or class. Of primary practical significance, however, is the fact that during the years the capital gains taxes were imposed, the two living remaindermen were the presumptive takers of the amounts accumulated for them.

In a case where an income tax is sought to be imposed, little or no significance is attached to nice distinctions among remainder interests, such as vested, contingent or vested subject to being divested. An illustration may be found in *Kent* v. *Rothensies*, 120 F. 2d 476 (3d Cir. 1941), *cert. denied*, 314 U. S. 659 (1941). A grantor created a trust under circumstances permitting the trust income to be taxed to the grantor. One half of the trust income was to be accumulated for two years and at the expiration of

two years was to be distributed to the grantor "if living". The grantor contended that his interest in such accumulated income was contingent and therefore he should not be subject to tax. The Third Circuit dismissed the grantor's contention as follows (at p. 479):

> "The plaintiff [grantor] is not only one of a number of persons to whom distribution may eventually be made but in fact is the presumptive taker of the trust accumulations. As a practical matter, so long as the plaintiff is alive the accumulations of the trust income are for him."

Such a practical approach commends itself in applying an exemption provision in an international treaty, most certainly where it can be shown that such an approach advances the underlying objective of the treaty exemption.[21]

The Court below did not question that there would be a burden on remainder interests, but questioned whether it was sufficiently clear that the burden would fall on United Kingdom residents, stating:

> "* * * [I]t is wholly unclear that the entire economic burden of the tax will fall on United Kingdom residents. Since the tax constitutes a charge on corpus, it will affect the present beneficiary only slightly by reducing the income; and it is difficult to say now that when the ultimate recipients of the corpus take, they will all be residents of the United Kingdom" (R. 28).

However, under our income tax law a capital gains tax can be imposed only in the year of the sale of the capital assets, and the exemption can therefore be applied, if at

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[21] The Tax Court has recently held in *Lambert Tree Trust Estate*, 38 T. C. 392 (1962) that *American Trust Company* v. *Smyth*, *supra*, is not controlling where the remainder interests are contingent in nature.

all, only in the year of sale. An analogous situation exists under Section 642(c) of the Internal Revenue Code, which provides for a deduction for any amount of the gross income of a trust which is "paid or permanently set aside" for charitable purposes. Both the courts and the Treasury interpret Section 642(c) as providing a complete deduction for capital gains set aside for future charitable distribution without any diminution for the value of an intervening life estate and even though at the time of distribution the exempt status of the beneficiary may have changed. *Hopkins v. Commissioner*, 13 T. C. 952 (1949), *appeal dismissed per stipulation* C. C. A. 9, June 19, 1950, 1950 P-H Fed. Tax. Serv. ¶71,098, Regulations §1.642(c)-3, S. M. 4644, V-1 Cum. Bull. 277 (1926), A. R. R. 521, 4 Cum. Bull. 221 (1921).[22] Section 642(c) thus recognizes that notwithstanding the presence of legal title in the trustee, the present owner of any capital gains realized by a trust is the charitable remainderman, who would suffer an immediate economic impact from any tax imposed on these gains.

4. Under the Terms of the Treaty the Exemption for the United Kingdom Beneficiaries Is Not Defeated by the Interposition of a Domestic Trust.

The Court below found that the "technical language" of the Convention, in conjunction with the Internal Revenue Code, "as incorporated by Article II(3)" recognizes a trust as a separate taxable entity (R. 28), since Article II(1)(g) defines a "resident of the United Kingdom" as "any *person* (other than a citizen of the United States or a United States

[22] Other events could conceivably prevent the charity from receiving the income or capital gains exempted from tax, but those events are also ignored. Such events would include (1) a severe decline in the value of the gross assets of the trust, and (2) unusually large expenses incurred upon the termination of the trust and chargeable to corpus, such as expenses of an accounting proceeding. Moreover, the right of the charity to take the trust property may be defeated by an adverse claimant.

corporation) who is a resident in the United Kingdom for the purpose of United Kingdom tax and not resident in the United States for the purpose of United States tax" (emphasis added), the term "person" is not otherwise defined in the Treaty, and under Section 7701(a)(1) of the Internal Revenue Code of 1954 the term "person" embraces a trust (R. 22-3, footnote 2).

The difficulty with this position is that Section 7701(a) of the Code provides that the term "person shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." The interplay of Articles II(1)(g) and Article II(3) of the Treaty and our Internal Revenue Code merely state a truism, namely, that the trust is a person and that the individual beneficiaries are persons. The trust is resident in the United States and not resident in the United Kingdom; the beneficiaries are resident in the United Kingdom and not resident in the United States.

In seeking to deny the exemption in this case because the United States trust is a "person", the position of the Court below is virtually the same as the Government's unsuccessful argument in *Helvering* v. *Hutchings, supra*, n. 20.

In the *Hutchings* case, the government sought to permit one gift tax exclusion to a donor who made a gift to a single trust, whereas this Court permitted the donor an exclusion for each of seven beneficiaries of the trust. The government's argument was based on the ground that the statute allowed one deduction for each gift "made to any person" and the statutory definition of "person" embraced a trust. Justice Stone observed that the statutory definition of "person" was of little aid in helping to answer the question before the Court, noting that the Section defining person "means no more than that the

word 'person' in any Section of the act in which it occurs may be taken as meaning 'trust' rather than 'individual' *as the context may require*" 312 U. S. at 395 (emphasis added). In the *Hutchings* case, the equitable owners of the trust property were the beneficial owners of the gift to the trust; the bare legal title of the trustee, or the trust as such, was considered of lesser importance even though the trust was, by statutory definition, a "person".[23]

If there had been a clear intent to permit the "separate existence" of a domestic trust to defeat the exemption by the terms of the Treaty itself, a ready method was at hand. All of the treaties prior to the United Kingdom Convention contained a "saving clause" which had the precise effect sought by the Government in this case.[24] The typical saving clause provides:[25]

> "Notwithstanding any other provisions of this convention, the United States of America in determining the income and excess-profits taxes, including all surtaxes, of its citizens or residents or corporations, may include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States of America as though this convention had not come into effect."

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[23] By way of contrast, a different rule applies to a gift to a corporation where there is only one gift tax exemption, notwithstanding the indirect proportionate benefits derived from such gift by the stockholders. See *Heringer* v. *Commissioner*, *supra*, n. 20. The concept of a corporation as a separate juridical person or entity is basic in the laws of the United States and England and is expressly recognized in the Treaty definitions.

[24] Sweden, March 23, 1939, 54 Stat. 1767, Art. XIV(a); Canada, March 4, 1942, 56 Stat. 1404, Art. XVII; France, July 15, 1939, 59 Stat. 900, Art. 14A.

[25] Treaty with Sweden, Art. XIV(a). The saving clause is always part of the provision of a treaty granting credits for foreign taxes on a reciprocal basis, and accordingly does not vitiate the foreign tax credit provisions. When the object of a treaty is to eliminate double taxation, the reciprocal credit provision combined with a saving clause adequately serves the purpose.

With the exception of certain of our treaties with English-speaking or Commonwealth countries, all of our treaties have included a saving clause substantially in the form quoted above. In all, sixteen conventions contain the standard saving clause.[26] The six other conventions contain language substantially identical to the definitional provisions of Article II of the United Kingdom Convention.[27] In most instances the definitional provisions of Article II of the United Kingdom Convention have the same effect as the standard saving clause found in the other conventions. Thus, the definition of "resident of the United Kingdom" in Article II(1)(g) specifically excludes from its coverage "a citizen of the United States" and "a United States corporation", or, stated differently, includes: "any person (other than a citizen of the United States or a United States corporation) who is a resident in the United Kingdom for the purposes of United Kingdom tax and not resi-

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[26] Austria, Oct. 25, 1956 [1957] 2 U. S. T. & O. I. A. 1699, 1708, Art. XV(1); Belgium, Oct. 28, 1948 [1953] 2 U. S. T. & O. I. A. 1647, 1622, Art. XII(1); Canada, *supra* n. 24 Art. XVII; Denmark, May 6, 1948, 62 Stat. 1730, 1735, Art. XV(a); Finland, March 3, 1952 [1952] 3 U. S. T. & O. I. A. 4485, 4492, Art. XV(1)(a); France, *supra* n. 24 Art. 14A; Germany, July 22, 1954 [1954] 3 U. S. T. & O. I. A. 2768, 2798, Art. XV(1)(a); Greece, Jan. 20, 1950, [1954] 1 U. S. T. & O. I. A. 47, 69, Art. XIV(1); Honduras, June 25, 1956, [1957] 1 U. S. T. & O. I. A. 219, 228, Art. XVI(1)(a); Italy, March 30, 1955 [1956] 3 U. S. T. & O. I. A. 2999, 3011, Art. XV(1)(a); Japan, April 16, 1954 [1955] 1 U. S. T. & O. I. A. 149, 162, Art. XIV(a); Netherlands, April 29, 1948, 62 Stat. 1757, 1764, Art. XIX(1); Norway, June 13, 1949 [1951] 2 U. S. T. & O. I. A. 2323, 2329, Art. XIV (1)(a); Sweden, *supra* n. 24 Art. XIV(a); Switzerland, May 24, 1951 [1951] 2 U. S. T. & O. I. A. 1751, 1759 Art. XV(1)(a); Union of South Africa, Dec. 13, 1946 [1952] 3 U. S. T. & O. I. A. 3821, 3825, Art. IV(1).

[27] Australia, May 14, 1953 [1953] 2 U. S. T. & O. I. A. 2274, 2277, Art. II(1)(f); India, Nov. 10, 1959, Department of State Release Number 783 (Ratification Pending), Art. II(1)(b); Ireland, Sept. 13, 1949 [1951] 2 U. S. T. & O. I. A. 2303, 2307, Art. II(1)(g); New Zealand, March 16, 1948 [1951] 2 U. S. T. & O. I. A. 2378, 2380, Art. II(1)(j); Pakistan, July 1, 1957 [1959] 1 U. S. T. & O. I. A. 984, 986, Art. II(1)(i); United Kingdom, Art. II(1)(g).

dent in the United States for purposes of United States tax."

There is nevertheless a marked difference between the standard saving clause and the definitional provisions found in Article II of the Treaty.

The standard saving clause would expressly provide that the United States may tax the capital gains of a United States trust "notwithstanding any other provisions of this Convention" (Article XIV in this case), and "as though this Convention had not come into effect". The standard saving clause would extinguish the exemption of Article XIV in any consideration of this case. The exemption is not extinguished by the definitional provisions in Article II of the United Kingdom Treaty and such provisions have no similar overriding power.

Under the Treaty, any term not otherwise defined shall have the meaning given it by the laws of the country which is applying the Treaty to a question of domestic taxation "unless the context otherwise requires". Whether the term "person", with reference to "resident of the United Kingdom" means a trust without regard to the status of the beneficiaries, or the individuals who are beneficiaries without regard to the status of the trust, necessarily depends upon the context in which it is found. For example, Articles VI, VII, VIII and IX of the Treaty deal, respectively, with dividends, interest, copyright and trademark royalties and mineral royalties. In each case, the United States domestic rules of taxation give way to the treaty provisions if the item of income is "derived by" a resident of the United Kingdom "who is subject to tax on" or "with respect to" such income. If such items of income are accumulated in a domestic trust for future distribution to United Kingdom beneficiaries, it would appear, in the context of those treaty provisions, that the United Kingdom

beneficiaries are not the persons to whom such provisions were intended to apply. However, similar language is absent from Article XIV, even though in large part found in the capital gain provisions of the three treaties entered into before the United Kingdom treaty was secured.[28]

In contrast to such other provisions, the broad mandate of Article XIV invites a liberal construction if its underlying purpose is to be achieved.

It is of course true that in a technical sense the trust in this case is the "taxpayer", but the beneficiaries bear the burden of the tax, and only in a narrow technical sense has "exempt from United States tax" any substantive bearing on the domestic trust. This Court has refused to apply a technical meaning to a tax exemption when the circumstances justified a liberal meaning.

Prior to the allowance of any deduction in respect of the income of a trust or estate "permanently set aside" for a charity, the question arose whether the income of a testamentary trust, which income would pass to a tax-exempt hospital upon the death of an annuitant, was exempt (the statutory language was "shall not be taxed"). *Lederer v. Stockton*, 260 U. S. 3 (1922). The Supreme Court of Pennsylvania had held that the income on the bequest could not be paid to the charity until the death of the annuitant, and that until such event occurred the income must remain in the control of the trustee under the will. Faced with this situation, the trustee transferred the entire bequest as a loan to the hospital secured by a mortgage on the hospital property, under the terms of which the hospital would pay only interest enough to satisfy the administrative charges and the remaining annuity, using the remain-

[28] In each of the prior treaties, the gain must have been derived from the sale or exchange of capital assets by a resident of the other state. See *supra*, pp. 18-19.

der for its own purposes. The government contended that the trust as interpreted by the Supreme Court of Pennsylvania was an active trust and one which could not be terminated, and accordingly the income in question was not "income received" by a charity and so not within the exemption. Nevertheless, this Court held that the income was not subject to tax.

This Court analyzed our domestic scheme of taxing trust income in *Helvering* v. *Butterworth*, 290 U. S. 365 (1933), and *Freuler* v. *Helvering*, 291 U. S. 35 (1934). Congress, it was said, did not intend that any income from a trust should escape taxation. But in the *Butterworth* case this Court added significantly "unless definitely exempted" 290 U. S. at 369. Our scheme of taxing trusts insures that taxable income is taxed at least once, either to the beneficiary if the income is currently distributed or distributable, or to the trust if the income is accumulated for future distribution. A trust, however, does not change the character of the income that is screened through it.[29] A trust does not create a tax on income that is intended to be exempt.

While the separate entity concept of a trust is repeatedly brushed aside in domestic tax controversies, examples can be found where the separate existence of an estate or trust and literal provisions of the ~~Code have~~ been magnified to the extreme. The Tax Court adopted such an approach

[29] This rule is now a part of the Internal Revenue Code, Sections 643, 652 and 662, but it antedated express statutory provisions. Thus in *Helvering* v. *Falk*, 291 U. S. 183 (1934), this Court allowed the beneficiaries of a trust a deduction for percentage depletion on mineral property held by the trust even though, as the government argued, the statute required the beneficiaries to include the entire distribution from the trust in income and made no provision for the allowance to the beneficiaries of a deduction with respect to property held by the trust.

in *Estate of Emily St. A. Tait*, 11 T. C. 731 (1948),[30] but since the approach quite obviously defeated a treaty exemption, the Treasury issued a ruling repudiating the Tax Court decision in the case, stating (I. T. 4019, 1950-2 Cum. Bull. 58, 60):

> "To disallow the deductions in such cases would have the effect of taxing income which is specifically exempted by Treaty.
>
> * * * if the income is 'definitely exempted' by treaty provisions, effect must be given to such provisions."

5. Since Congress Adopted the Treaty Exemption Unconditionally and Without Limitation, the Exemption Should Be Construed so as to Secure the Intended Equality and Reciprocity of Treatment.

We are dealing not only with an exemption granted by an international treaty, but also with that same exemption expressly implemented by Congress in a manner sufficient to resolve conflicting rules of domestic tax law in favor of the Treaty exemption.

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[30] The petitioner in the *Tait* case, an American ancillary administrator of a Canadian estate, had made annuity payments to Canadian residents, who were exempt by Treaty from United States tax on pension income, and claimed as a deduction in the fiduciary return the amount of such payments. The Tax Court held the estate taxable on the income received and paid to the annuitants and denied deduction of the annuity payments, since, under Section 162 of the Internal Revenue Code of 1939, the "amount so allowed as a deduction shall be included when computing the net income of the beneficiary", citing *Helvering* v. *Butterworth*, *supra*, to the effect that "the income of an estate is to be taxed to either the fiduciary or the beneficiary distributee, and that it may not be permitted to escape tax by falling in some way between the two". The technical effect of the decision was to impose the tax, not on the distributee who was exempt under the Treaty, but upon the trustee, who was not exempt. Following an appeal, taken by the taxpayer to the United States Court of Appeals, the case was remanded to the Tax Court by stipulation by both parties. (C. C. A. 4, 1949 P-H Fed. Tax Serv. ¶71,107). Pursuant to stipulation of the parties, the Tax Court entered a final decision of no deficiency. (1949 P-H Fed. Tax. Serv. ¶74,290).

Section 894 of the Internal Revenue Code of 1954, 26 U. S. C. §894, provides: "Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle." Thus, unconditionally and without limitation, our Internal Revenue Code exempts from taxation income of any kind and to the extent required by any treaty obligation. This provision was first enacted in 1936, and has since remained intact in our otherwise everchanging revenue laws.

Congress has not rested on this blanket incorporation of treaty exemption for "income of any kind", and "to the extent required" by any treaty obligation. Congress expressly provided, in Section 7852(d) of the Internal Revenue Code of 1954:

> "No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title." 26 U. S. C. §7852(d).

The treaty exemption overrides domestic tax rules, and is intended by Congress to be upheld as found in the four corners of the treaty itself.

Since both treaties and acts of Congress are the supreme law of the land, this Court has endeavored to construe them, where they relate to the same subject, so as to give effect to both, if that can be done without violating the language of either. There is no need here, however, to weigh domestic concepts in an effort to narrow a construction of Article XIV, since Congress has eliminated concern as to conflict with domestic law by enactment of Internal Revenue Code Sections 894 and 7852(d).

The interpretation of Article XIV should therefore be governed by the repeatedly enunciated principle that a

treaty should be liberally construed so as to carry out the objectives of the contracting parties. In *Geofroy* v. *Riggs*, *supra*, p. 13,[31] this Court said (132 U. S. at 271):

> "It is a general principle of construction with respect to treaties that they shall be liberally construed, so as to carry out the apparent intention of the parties to secure equality and reciprocity between them. As they are contracts between independent nations, in their construction words are to be taken in their ordinary meaning, as understood in the public law of nations, and not in any artificial or special sense impressed upon them by local law, unless such restricted sense is clearly intended. And it has been held by this court that where a treaty admits of two constructions, one restrictive of rights that may be claimed under it and the other favorable to them, the latter is to be preferred."

See also *Hauenstein* v. *Lynham*, 100 U. S. 483 (1879); *In re Ross*, *supra*, p. 19; *Jordan* v. *Tashiro*, 278 U. S. 123 (1928); *Factor* v. *Laubenheimer*, 290 U. S. 276 (1933).

As stated by this Court more recently, "This Court has many times set its face against treaty interpretations that unduly restrict rights a treaty is adopted to protect." *Kolovrat* v. *Oregon*, 366 U. S. 187, 193 (1961).

The Ninth Circuit in the *American Trust Company* case embraced a liberal construction of Article XIV in order to

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[31] In *Geofroy* v. *Riggs*, a treaty between the United States with France insured equality between the nationals of the two countries with respect to the possession and disposal of personal and real property "in all the states of the union", and, with respect to France, "within its territories". The claimant, a citizen of France, asserted the right to inherit real estate in the District of Columbia. Unless the phrase "states of the union" included such political bodies as the District of Columbia and our territories, full reciprocity would not be attained. This Court held that the phrase "states of the union" embraced the District of Columbia.

carry out the apparent intention of the parties to secure equality and reciprocity between the parties to the Convention. *American Trust Company* v. *Smyth*, 247 F. 2d at 152-53. The decision in the *American Trust Company* case achieves reciprocity. The decision of the Court below does not.

II.

The Treasury Regulations Fail to Deal With the Unique Terms of the United Kingdom Treaty, Lack Express Sanction in the Treaty, and Should Not Be Given Controlling Weight.

In reaching its conclusion that the gains in this case are taxable, the Court below also relied upon the Treasury Regulations interpreting the Treaty. T. D. 5569, 1947-2 Cum. Bull. 100, §7.519(c), (R. 28-29).

Section 7.519 of the Regulations, which purports to determine the extent to which gains in trust are eligible for the Article XIV exemption, provides:

> "(c) Beneficiaries of an estate or trust.—A nonresident alien who is a resident of the United Kingdom and who is a beneficiary of a domestic estate or trust, shall be entitled to the exemption, or reduction in the rate of tax, as the case may be, provided in Articles VI, VII, VIII, IX and XIV of the convention with respect to dividends, interest, royalties, natural resource royalties, rentals from real property and capital gains to the extent such item or items are included in his distributive share of income of such estate or trust if he is taxable in the United Kingdom on such income and is not engaged in trade or business in the United States through a permanent establishment." T. D. 5569, 1947-2 Cum. Bull. 100 at 114.

These regulations contain a patent defect. It is stated that a United Kingdom resident "who is a beneficiary of a domestic trust" shall be entitled to the exemption or reductions in the rate of tax with respect to "dividends, interest, royalties, natural resource royalties, rentals from real property and capital gains" when such items are included in his distributed share "if he is taxable in the United Kingdom on such income and is not engaged in trade or business in the United States through a permanent establishment". Capital gains realized by a trust are not subject to tax in the United Kingdom, whether the trust is a United Kingdom trust or a United States trust. Thus, the qualifying clause "if he is taxable in the United Kingdom on such income", while appropriate in the case of the other recited items, is entirely inappropriate in respect to a capital gain. Indeed the treaty itself imposes the same limitation with the sole exception of capital gains under Article XIV.

Similarly, the requirement that capital gains must be included in the beneficiary's distributive share of the income of a trust appears nowhere in Article XIV. While this requirement is reasonable in the case of dividends, interest, royalties and rentals, which almost always constitute income in the trust accounting sense, it would render Article XIV largely inoperative in the case of capital gains, which are normally treated as items of trust corpus accumulated for the benefit of the remainderman.

The Court below made no reference to these considerations, perhaps because, to use its own words (R. 29):

> "A similar position recognizing that the trust is a separate taxable entity for the purpose of determining treaty exemptions has been taken in the interpretation of all our tax conventions."

However, as we have shown above, most of these other treaties contain quite different language, so that their interpretation is in no respects controlling here.

One other provision of T. D. 5569 is also pertinent. Section 7.514 sets forth the specific classes of income from sources within the United States which are considered exempt under the Convention. Among these are:

> "(g) Gains from the sale or exchange of capital assets by a nonresident alien who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom, if such alien or corporation has no permanent establishment in the United States (Article XIV);" T. D. 5569, 1947-2 Cum. Bull. 100 at 110.

See also Section 7.523.

This subparagraph is appropriate when applied in the case of property directly owned by a resident of the United Kingdom. It does not undertake to apply to property held in trust, which is specifically dealt with in Section 7.519(c). But if Section 7.514(g) were considered as having general application, its limited language, "Gains from the sale * * * of capital assets by a nonresident alien", does not reflect the broad language of Article XIV, "A resident of the United Kingdom * * * shall be exempt from United States tax on gains from the sale * * * of capital assets". Instead Section 7.519(c) reflects the quite different language of the three earlier treaties and is the same as the Regulations under those treaties.[32] However, it is certainly not fully responsive to the language of the treaty exemption provided by Article XIV.

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[32] Canada, T. D. 5206; Sec. 7.21(f), 1943 Cum. Bull. 526, 534; France, T. D. 5499, Sec. 7.412(g), 1946-1 Cum. Bull. 134, 142; Sweden, T. D. 4975, Sec. 25.1(d), 1940-2 Cum. Bull. 43, 51.

It is significant that the Regulations under the United Kingdom Treaty were not issued pursuant to any authority granted by that Treaty, but instead were promulgated under the general power granted to the Commissioner under Section 62 of the 1939 Code, 53 Stat. 32, (the predecessor of 1954 Code Section 7805, 26 U. S. C. §7805) to issue regulations "for the enforcement of the chapter", namely, the income tax chapter of the Internal Revenue Code. This is important since all of the three tax treaties which were ratified by the United States prior to the ratification of the United Kingdom Treaty contain express authority for the prescription of regulations, so that the regulations under those treaties thus have the express sanction of the treaties themselves.[33] While the courts have given great weight to the administrative regulations under these treaties,[34] the absence of any similar provision under the United Kingdom Treaty makes it appropriate to view with skepticism any regulation promulgated solely under the authority of our domestic law which takes a restrictive view of the rights granted to United Kingdom residents by a compact between two sovereign states.

This Court in the past has refused to follow tax regulations when to do so would "create a rule out of harmony with the statute." *Manhattan General Equipment Co.* v. *Commissioner,* 297 U. S. 129, 134 (1936). See also *Commissioner* v. *Acker,* 361 U. S. 87, 92 (1959), *United States*

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[33] Treaty between the United States and Sweden, March 23, 1939, 54 Stat. 1773, Art. XXI; Treaty between the United States and Canada, March 4, 1942, 56 Stat. 1405, Art. XVIII; Treaty between the United States and France, July 25, 1939, 59 Stat. 908, Art. 26, (superseded by Art. 1[illegible] of Supplemental Convention, October 18, 1946, 64 Stat. B21). Of the seventeen United States tax treaties ratified since the United Kingdom Treaty, fifteen contain specific language authorizing the promulgation of regulations.

[34] *E.g. Lewenhaupt* v. *Commissioner,* 20 T. C. 151 (1953), *aff'd per curiam,* 221 F. 2d 227 (9th Cir. 1955).

v. *Calamaro,* 354 U. S. 351, 359 (1957) and *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, 376-377 (1945). Similarly, the Regulations involved in this case would create a rule which is unresponsive to the broad mandate of Article XIV, and hence should not be given controlling weight.

Conclusion.

The judgment of the Court of Appeals should be reversed and the decision of the District Court affirmed.

Respectfully submitted,

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January 31, 1963.